

Chapter 3 Recent Trends in Airline Alliances

3.1 Introduction

Although the first alliances between airlines appeared 30 years ago, it is only since the late 1990s that their prevalence has soared. The first airline alliances arose in the US domestic airline industry. A number of domestic carriers sought to achieve cost savings and to better utilise capacity through the operation of joint services and code sharing. Since then, alliances have expanded into other airline markets as well as between countries, region and on a global basis.

In recent years, airlines have sought to extend the reach of many of their networks through alliances and have entered into arrangements with a number of airline partners. This chapter will discuss the nature of international airline alliance and some evidence of the growth in alliance activity in recent years, thus will answer to three main issues of this paper.

3.1.1 The nature of airline alliances

The term 'alliance' is often used to describe an accord, partnership, cooperative agreement, joint operation, marketing alliance or 'code sharing' agreement.

Airlines have traditionally entered into 'interline agreements' involving the coordination of, for example, baggage checks, carriage of air cargo and honouring of tickets between airlines. These arrangements are generally aimed at facilitating international passenger movements. Under an interline agreement, the identity of each carrier is maintained separately.

However, Airlines have increasingly sought to incorporate a wider range of activities in their agreements. As a result, the nature of alliances may differ

markedly depending on the range of operations that airlines choose to coordinate. For example, alliances may allow airlines to:

- code share or jointly operate flights;
- coordinate scheduling of aircraft arrival and departure times;
- coordinate the location arrival and departure gates;
- coordinate frequent flyer schemes;
- share airport lounges and other ground facilities;
- coordinate and streamline passenger services such as baggage handling, check-in and ticketing;
- coordinate support services including maintenance and catering; and
- share distribution and retailing functions.

Alliances may be simple, coordinating just one element of operations. Alternatively airlines may enter into complex global alliances whereby partners code share on a large number of routes so as to strategically link their flight networks. Global alliances also often involve high integration and coordination of flights, scheduling, advertising and frequent flyer programmes. Examples of global alliances include the One World, KLM/Northwest, Star Alliance and Atlantic Excellence. Appendix B-E will outline the four of the biggest alliances group formed and the airlines involved.

International airline alliances sometimes incorporate equity holding arrangements, although the amount of equity that can be held is typically limited in each country. For example, as part of their recently agreed airline alliance, Singapore Airlines purchased 49 percent of Virgin Atlantic stake at more than £1.2 billion on Monday, 20 December 1999. The world's two best airlines with an unparalleled reputation for quality and innovation are delighted to announce a unique global partnership. Under the terms of the deal, Singapore Airlines will acquire a minority stake of 49% of Virgin Atlantic, the holding company of Virgin

Atlantic Airways, Virgin Holidays, Virgin Sun and Virgin's cargo operation, Virgin Aviation Services¹¹.

The cost of the transaction to Singapore Airlines is £600.25 million, which includes a capital injection of £49 million. Virgin will reinvest a further £51 million into Virgin Atlantic. This transaction for a minority equity investment values Virgin Atlantic at a minimum of £1.225 billion.

Table 2

Singapore Airlines acquisition in Virgin Atlantic

Item	Virgin Atlantic	Singapore Airlines
% Stake	51%	49%
Costs	£1.225 billion including reinvestment of £51 million into Virgin Atlantic	£600.25 million including a capital injection of US 49 million into Virgin Atlantic

Source: Electronic Telegraph, Issue 1670, Tuesday 21/12/99; 'Branson sells 49pc Stake to Singapore Air' by Roland Gibben, Business Editor

Singapore Airlines operate a fleet of 93 aircraft to 97 world-wide destinations and had total sales of US\$4.4 billion for the year ended 31 March 1999. Virgin Atlantic, the UK's second largest scheduled airline, operates a fleet of 29 aircraft to 18 destinations in Europe, Africa and the United States with total sales in excess of £1 billion in the year ended 30 April 1999. The two carriers' network do not overlap on any destinations and are uniquely complementary. At the same time, they will enter into agreements to co-operate in a range of initiatives including code sharing, enhancement of their frequent flyer programmes, shared access to passenger lounges and airport facilities. The tie-up gives Virgin Atlantic access to Singapore's strong Asian network, while Singapore will achieve its ambition of breaking into north Atlantic routes and becoming a global airline.

¹¹ Electronic Telegraph; City News Headlines, Tuesday 21 December 1999 'Branson sells 49% stake to Singapore Air'

This partnership will give a stiffer competition to British Airways as from the deal, Virgin Atlantic's position at Heathrow would be strengthened. Malaysia Airlines was widely thought to be in precarious position as it stood to lose the arrangement on the Kuala Lumpur-London sector for Virgin Atlantic flights. The code share agreement is for a ten-year period commencement June 1, 1995. The agreement essentially give Malaysia Airlines the right to mount joint services on KL-London flights up to twice daily, using its aircraft but with a shared crew and flight number. A termination of this arrangement will effectively halve the capacity offered by Malaysia Airlines in the sector. There is five years yet to go on the agreement and that gives Malaysia Airlines enough time to study its options, However, it is unclear if an opt-out clause exists and what the conditions to terminating the agreement are.

Code sharing is a key element of many international airline alliances. Under a code share agreement, one partner (the code sharing partner) assigns its airline designator code to a flight of its partner (the operating carrier). Typically code sharing is accompanied by a suite of other coordinated services designed to provide passengers with smooth connections between flights operated by the partner carriers.

There are numbers of ways that carriers can execute a code share arrangement. One partner may purchase a block of seat from the other, with the number of seats available to the code share partner determined up front. Other alliances operate under 'wet leases' where one airline leases an aircraft and its crew from another carrier. Alternatively, the agreement may require the code-sharing partner to contact the operating carrier each time a customer request for a seat. The most complex alliances operate sophisticated computerised seat management systems that allow both partners that allow both partners to manage the capacity on a seat by seat basis.

The 'reach' of airline alliances may also differ. For example, airline may enter into alliances or agreements, which enable services to be operated jointly on a particular route, on a range of flights within a region, or on a global basis coordinating activities over many countries.

Route or point-specific alliances are the most common. Under a route or point-specific alliance the airline partners code share on a small number of city-pair markets. These agreements often involve one airline buying blocks of seats on the other's flights and reselling them. Malaysia Airlines and Ansett Australia operate a route-specific alliance, which involves code sharing on flights between Kuala Lumpur and Melbourne and Sydney.

Regional alliances have wider scope involving cooperation on a limited number of routes within a region. For example, the agreement between Malaysia Airlines and British Midlands enables passengers to travel to London and connect with British Midlands's flights to destinations within Europe such as Leeds, Teesside and Glasgow.

Several regional alliances, which connect a limited number of routes to and from a specific region, have generated modest traffic gains for the carriers involved. A high level of integration has characterized successful alliances. For example, over the last 2 years, United and Ansett Australia have worked closely to develop and market their alliance. Approximately over 50,000 passengers per year are traveling on United between Sydney and the United States that are also connecting to Ansett flights between Sydney and eight interior Australian cities. Before the alliance, United did not serve these cities. Through code-sharing with Ansett, United can market service to these cities through the CRSs.

Some carriers operate a large number of alliances. For example, in 1999 the Air France group operated 33 separate agreements, Malaysia Airlines operated 31, Swissair 30 and American Airlines 28. Please refer to Table 3 for more details.

Table 3

Lead Alliance Partner	
Airline	Alliances
Air France	33
Malaysia Airlines	31
Swissair	30
American Airlines	28

Source: Airline Business, July 1999' Alliances Global groupings'

Code sharing, a feature of many alliances, has grown rapidly in recent years. In 1995 there was 150 international code sharing agreements worldwide. This is six times the number that existed five years earlier¹². Please refer to Table 4 for details.

Table 4

Alliance development in the global airline industry, 1994-1999

	1994	1995	1996	1997	1998	1999
Number of alliances with equity stakes ^a	58	58	62	54	56	53
Number of alliances with non-equity stakes	222	266	327	309	446	460
New Alliances ^b	na	50	71	72	121	26
Number of Airlines	136	153	159	177	196	204
Number of Alliances	280	324	389	363	502	513

Na Not Available

a Includes new alliances

b Alliances started that year

Source: Airline Business, June 1997, June 1998 and July 1999

¹² British Consultant Group Survey 1995

Alliances are fluid arrangements. Airlines are continuously disbanding old arrangements and entering into new ones. Whilst some alliances may continue for years others may operate for only a short period of time.

The Boston Consulting Group (BCG 1995) identified that alliances involving equity appear to have a higher survival rate compared to those without any equity arrangements.

There are a number of other factors that influence the success of an alliance. Example include clarity of strategic goals, commitment of resources, commitment of management, complementary of route networks, realisable cost saving, compatibility of product service standards and similarity of corporate styles. Conversely, reasons contributing to the failure of alliances include objectives being set too broadly, asymmetry of partners, asymmetry of benefits versus expectations, differing product and service standards, competing priorities and contrasting corporate styles.

3.1.2 Alliances in the Asia-Pacific region

Airlines in the Asia-Pacific region have been slower to form alliances than in other regions. It has been argued that this may be because is more diverse than Europe or North America, and that the airline industry in Asia-Pacific region is in a relatively early stage of its development and experiencing very high levels of growth. With opportunities for profitable individual expansion, the region's airlines may have been less forthcoming in forming alliances.

This region's airlines have largely approached the alliance era from a position of strength; they have generally coveted the US internal market nearly as much as the Europeans, and find much of their own thirst for expansion met by the booming intra-Asian and long haul markets. They have been much less ready to

enter strategic alliances – among the major airlines only Singapore Airlines, Thai International, Qantas and All Nippon Airways have comprehensive alliances and only the first three are full strategic pacts. Governments in the region remain instinctively protectionist in most trade matters, especially with regard to the USA, and air transport bilateral agreements are still among the most heavily restricted, limiting the scope for developing even those alliances which are agreed.

However, driven by a growing network of smaller intra-Asian pacts, there are signs Asian airlines may soon become more accommodating, and perhaps even more pro-active, in Alliances. There is some recent evidence to suggest that this is changing. Sue Wood of Air Transport Intelligence has conducted an annual survey of airline, which highlights some alliance arrangements made between airlines in this region, which has shown a dramatic rise of 40% since 1994.

Malaysia Airlines is a good example (Refer Appendix A). As at November 1999, Malaysia Airlines has collectively participated in 31 alliances, 75% more than the previous year. Since then, Malaysia Airlines has continued to expand their agreements to cover services to a wider number of destinations.

Appendix A presents the details of international airline alliances currently operated by Malaysia Airlines with a number of other international airlines. These alliances differ in the degree of integration and complexity. For example, Northwest participates in Malaysia Airlines frequent flyer programme as part of the alliance. Singapore Airlines and Malaysia Airlines operates joint shuttle services on Kuala Lumpur and Singapore route. Other alliances involve greater integration of operations and coordination of code sharing over a larger network. Malaysia Airlines is as some Asian airlines looking forward to allocate the necessary management time and investment to full-scale alliance development as stiffer competition arises. Please refer to Appendix F for recent news release on this matter.

3.2 Competitive Strategies Available for Airlines

It is widely recognised that the airline industry is currently undergoing major changes. There are three main strategies that international airlines are currently following to achieve competitive advantage. These strategies are the expansion of global route networks, marketing oriented strategies and cost control strategies. From the point of view of this study it is interesting to consider, how airline alliances fit into these competitive strategies.

3.2.1 Expansion of Global Networks

Globalisation is possibly the most significant trend affecting the airline industry today. Airlines standing to gain most from globalisation are those with high market shares and extensive geographical coverage. Competitive positioning strategies are aimed directly at expanding the route coverage and thus the market share of the company. The progressive deregulation of the industry is enabling an increasing number of airlines to use these strategies¹³. There are two factors that are crucial to achieving a strong competitive position through the expansion of the route network. The first one is the establishment of an efficient hub and spoke system. A hub and spoke system is such where services from spokes are fed into much larger central hub. The hubs, if there are more than one, are then linked by direct flights. The hub and spoke system presents many advantages to the international airline. These include extended market coverage, high load factors, effective control of traffic, reduced dependency on other carriers for connecting traffic, increased aircraft utilisation and lower unit costs per passenger. Virtually all the world's major carriers are currently using hub and spoke systems.

¹³ Hamill 1993, page 332-225 and OECD (1997) *The Future of International Air Transport Policy: Responding to Global Change*, Organisation for Economic Co-operation and Development, Paris

The second important issue in utilising an extended network strategy is slot access. Most of the world's largest airports are currently very congested. If an airline wants to expand to new hubs, they will have to bargain for the take-off and landing slots in that airport. Without slot access, the expansion of global networks is not possible. The acquisition of 49% of Virgin Atlantic stake would increase the take-off and landing slot for Singapore Airlines at Heathrow. This is one reason for fierce competition faced by British Airways.

Alliances are the prime instrument in utilising the global expansion strategies. As was stated before, alliances bring extensive new possibilities for growth. Alliances bring increased efficiency to hub and spoke systems as partners can cooperate in building larger hubs than ever before. The agreements also bring additional power to the battle for take-off and landing slots as the Singapore Airlines and Virgin Atlantic example clearly demonstrates.

3.2.2 Marketing and Customer Orientated Strategies

The marketing and customer orientated strategies are gaining significance among some of the world's leading carriers as they face a dynamic competitive environment. These strategies are aimed at securing customer satisfaction and loyalty. Users of the marketing strategies emphasize the development of international Computer Reservation Systems, FFPs, market segmentation, service orientation and branding, staffing and training as well as safety and security. Alliances also are assumed to enable airlines to advance in market segmentation and branding.

3.2.3 Cost Control Strategies

The airlines that are facing financial difficulties are resorting to cost control strategies. Cost cutting exhibits it in e.g. organisational restructuring, recruitment

freezes salary revisions and capital expenditure controls. Full service airlines only use these strategies in a time of crisis but the new low costs as long-term competitive strategy. In the longer term the instruments of cost control differ from those used in crisis management¹⁴.

Alliances are also compatible with cost control strategies. They enable participating airlines to eliminate overlap in their services and possibly learn new economical methods of operating from each other. For example, Malaysia Airlines has a reciprocal block-space agreements with 31 airlines around the world in which it purchases seats on their flights to specific cities or vice versa in order to reduce the cost.

3.3 Benefits derived by Airlines from alliances vary.

The majority of the 513 alliances to date involve arrangements that are more limited than strategic or regional alliances. These arrangements entail code-sharing in a small number of city-pair markets. Often times, alliances involve blocked-space agreements in which one carrier purchases a block of seats on another carrier's flights and sells them independently. Many of these arrangements have failed because the airlines involved compete against each other rather than effectively integrating their operations. Nevertheless, although they do not produce the same magnitude of benefits for airlines as strategic and regional alliances do, these alliances can be profitable if the partners effectively integrate their operations and marketing.

As of December 31, 1994, Department Of Transportation (DOT) had approved 50 point-specific alliances. Roughly one-third of these alliances have been terminated by the airlines involved because they failed to produce the traffic and revenues expected. For example, in 1992 American and Cathay Pacific terminated their blocked-space arrangement through which American purchased

¹⁴ Airline Business, January 1999 page 55

and resold seats on Cathay Pacific's flights between Los Angeles and Hong Kong. According to American representatives, the airline entered this agreement because it believed it would be too costly to fly the route itself although the number of passengers generated by the arrangement met expectations, but profit on the route were unsuccessful due to very low fares charged to attract passengers. Although consumers benefit from such reduced fares, Cathay had reduced the fares on its seats so low, that American had to lower its fares to the point that it could not make a profit.

Several point-specific, blocked-space alliances are producing benefits for partners. For example, Delta had blocked-space agreements with nine airlines around the globe in which it either purchases seats on their flights to specific cities or the foreign carrier purchases seats on Delta's flights. It is too costly to serve many of these points directly. In other cases, foreign carriers cannot afford to provide direct service.

Several of Delta's arrangements have been very successful for the carrier, in contrast to the airline's overall international results. The success of its alliances is occurring primarily because Delta has worked closely with each foreign partner to integrate operations and jointly market their arrangement. In its arrangement with Swissair, for example, Delta flight attendants are present on Swissair aircraft for flights between New York and Zurich. The airline has strict quality assurance procedures to which it and the foreign partner agree to adhere. Although declining to provide a specific estimate of revenue gains, the revenue produced by these alliances is especially important given that the airline ever lost \$338 million on international operations in 1994.

American Airlines and South African Airways have also developed a successful blocked-space arrangement. Between the alliance's implementation in November 1997 and September 1998, American sold over 20,600 seats on South African Airways' flights between New York and Johannesburg. This is because the

carrier has worked closely with South African Airways to develop their alliance and prevent situations similar to their experience with Cathay Pacific, the arrangement has been profitable for both airlines.

3.3.1 Potential Benefits and Threats for the Customer and Airline

There are a large number of potential benefits of airline alliances that can be found in current research, the professional press and airline marketing material. The most important potential benefits are outlined in the list below¹⁵.

3.3.1.1 Potential benefits to customer

- The customer is able to get more transportation services and access to a more extensive network from a single source.
- Interline connections are changed to preferred on-line connections in some cases and connecting times are reduced.
- Cost savings from service overlap elimination between the alliance partners brings lowered fares and possibly enhanced service.
- Collecting and using FFP bonus points becomes easier and more effective
- Increased competition caused by the alliance forces all the players in the market to enhance their services and or lower fares.

3.3.1.2 Potential Threats to Customer

- Increased fares due to limited competition and concentration of market power.
- Substandard levels of service caused by labour pooling, cost reductions and limited competition.
- Increased limitation on customer choice.

¹⁵ Airwise News, Monday, June 28, 1999 " Airline Alliances – A good thing?"

3.3.1.3 Potential Benefits to Airline

- Harmonisation of the partner airlines' schedules will make it easier for customers to arrange convenient connecting flights
- Connections at airports will be simpler as the two airlines are likely to locate their connecting gates closer together
- Ticketing will be simpler with all flight coupons on one ticket.

3.3.1.4 The Potential Threats to Airline

- Airfares will go up because competition from low-cost airlines will be stifled and it will be more difficult for smaller, low-fare competitors to enter the market
- Alliance partner will have no incentive to compete on price, service or capacity
- Partners airlines may eliminate some flights on overlapping routes. Travelers will thus have less flexibility and less choice because there will be fewer flights. Coming back an hour earlier or making a different flight an hour earlier or making a different flight connection can often cut the cost-fewer flights will remove this option
- Fares will go up because the airlines that have alliances will book passengers on their allied carrier thus cutting out smaller, cheaper airlines that have been filling gaps in service
- Merged frequent flyer points may be a short term benefit but it probably will cost more to earn those points